

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date:
September 13, 2011

Legend

Taxpayer =

Fund =

LLC =

Mineral =

State 1 =

State 2 =

State 3 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

a =

b =

c =

d =

e =

f =

g =

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i =

k =

m =

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Dear :

This responds to the letter dated June 20, 2011, and supplemental correspondence dated August 30, 2011, submitted by your authorized representative on behalf of Taxpayer. Taxpayer requests that the Internal Revenue Service rule that gross income realized by Taxpayer from payments made under a surface use agreement for the use of a surface estate in land constitutes “rents from real property” for purposes of section 856(c)(2)(C) and (c)(3)(A) of the Internal Revenue Code of 1986, as amended (the “Code”).

Facts

Taxpayer is a limited liability company incorporated in State 1 that has elected to be taxed as a real estate investment trust (“REIT”) beginning with its first taxable year, which ended on Date 1.

Taxpayer owns an a percent limited partnership interest in Fund, a State 1 limited partnership. Fund owns the sole membership interest in LLC, a State 2 limited liability company that, for federal income tax purposes, is disregarded as an entity separate from Fund. Fund’s purpose is to engage in the business of investing in timber-producing real property and certain rights and assets related to such real property, and in entities that own, manage, develop, harvest and sell such properties.

LLC owns the surface estate (the “Surface Estate”) in an area of timberlands located in State 3. Prior to Date 2, the mineral estate and surface estate with respect to the land (together, the “Property”) were held by a single person, subject to certain mineral leases granted by a prior owner. On Date 2, the owner of the Property conveyed all of its right, title and interest in all minerals on the Property (subject to the existing mineral leases) to another person (“Mineral Owner”). The deed effectuating the transfer acknowledged that the grantor’s rights to the surface and timber were subordinate and inferior to those of the Mineral Owner to the minerals. After Date 2, an individual not related to Taxpayer (“Individual”) acquired the Surface Estate. On Date 3, Individual and a mining company that is the lessee under one of the mineral leases (“Mining”) entered into a surface use agreement governing Mining’s use of the surface of the Property (the “SUA”). Taxpayer represents that none of Fund, LLC or the Taxpayer owns any interest in, or is under common control with, any of Mineral Owner, Mining, or any business controlled by Individual.

LLC acquired the Surface Estate from Individual on Date 4 in exchange for \$b. LLC succeeded Individual as the lessor under the SUA in accordance with its terms. Neither Taxpayer nor any affiliated entity acquired rights to the minerals under the Surface Estate in or since that transaction.

Mining wished to enter into the SUA to clarify and extend its rights to use the surface of the Property. Under the laws of State 3 and the terms of Mining’s lease (to which the rights of LLC are subject), Mining is permitted to conduct its mining activities and to disturb the surface of the Property without the consent of LLC. Changes in the law of State 3, however, raised concerns that Mining could be required to pay damages to the owner of the Surface Estate for the destruction of the surface of the Property. Mining also wished to assure its rights to the surface upon expiration of its lease with Mineral Owner and with respect to additional areas on which it sought to lease minerals from Mineral Owner. Mineral Owner has sufficient rights under its deed that it could confer the same broad rights to the surface as under the current lease, without the consent of LLC. Mining was able to secure such rights directly from Individual, however, under the SUA.

Under the SUA, the lessor grants the lessee the “full and unfettered right to any and all use of the surface” of the Property including the right to damage the surface through its mining activities. In lieu of any damages the surface owner might claim, the SUA provides for payments from the lessee (Mining) to the lessor (now LLC) based on the amount and sales price of the Mineral removed or transported (the “Payments”). Specifically, Mining is required to pay: (1) an amount per ton of Mineral mined and removed from the Property equal to the greater of (i) \$c, or (ii) d% of the sales price of such Mineral; and (2) an amount per ton of Mineral transported across (but not mined from) the Property equal to the greater of (i) \$e, or (ii) f% of the sales price of the Mineral. The SUA provides for an advance minimum payment of \$g per year, which is set off against the first \$g that would otherwise be payable under the per-ton payments.

The SUA preserves to the lessor the right to remove timber from the Property provided that the removal cannot interfere with the mining activities of lessee. As lessee, Mining is not liable for any damage to the timber through the activities permitted under the SUA if it provides the required advance notice to the lessor of timber that might be destroyed.

The original term of the SUA is h years and is automatically renewable for i successive renewal periods of j years unless sooner terminated. Mining can terminate the SUA if it determines that the Mineral on or near the leased premises cannot be mined or transported at a profit, and in certain other circumstances. LLC can terminate the SUA if there is no mining on the Property for a specified period.

For its first taxable year, LLC received a total payment under the SUA of \$k. Taxpayer realized income in the amount of \$m by virtue of its partnership interest in Fund. Taxpayer's other income for such year was interest income in the amount of \$n that is permitted under section 856(c)(2)(B) and meets the definition of qualified temporary investment income under section 856(c)(3)(I).

Law and Analysis

Section 856(c) provides that, to qualify as a REIT for any taxable year under part II of subchapter M, an entity must derive at least 95 percent of its gross income (excluding gross income from prohibited transactions) from the sources listed in section 856(c)(2), which includes rents from real property, and at least 75 percent of its gross income (excluding gross income from prohibited transactions) from sources listed in section 856(c)(3), which also includes rents from real property.

Section 856(d)(1) provides that, subject to the exclusions in section 856(d)(2), the term "rents from real property" includes (among other things) "rents from interests in real property." Section 1.856-4(a) of the Income Tax Regulations provides that, subject to the exceptions of section 856(d) and section 1.856-4(b), the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

Under section 1.856-3(d), the term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon. It also includes interests in real property. Local law definitions are not controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder.

Section 856(c)(5)(C) provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests. Section 1.856-3(c) provides specifically that "a retained

economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply” is within the exclusion for mineral, oil, or gas royalty interests.

Section 856(d)(2)(A) provides that, subject to certain exceptions, the term “rents from real property” does not include any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term “rents from real property” solely by reason of being based on a fixed percentage or percentages of receipts or sales).

Section 1.856-4(b)(3) provides that an amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as “rents from real property” if (i) the determinable amounts do not depend on the income or profits of the lessee and (ii) the percentages and determinable amounts are fixed at the time the lease is entered into and are not renegotiated during the term of the lease in a manner which has the effect of basing rent on income or profits. It further provides that an amount will not qualify as “rents from real property” if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits.

Section 1.856-3(g) provides that a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets is determined by reference to its capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership remains the same in the hands of the partners for all purposes of section 856.

The legislative history underlying the tax treatment of REITs indicates that the central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-823 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Section 631(c) provides capital gain or loss treatment for certain gains or losses from the disposal of coal or iron ore mined in the United States, held for more than one year before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore. Section 631(c) does not apply to income realized by any owner as a co-adventurer, partner, or principal

in the mining of such coal or iron ore, and the word “owner” means any person who owns an economic interest in coal or iron ore in place, including a sublessor.

Section 1.611-1(b) provides that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. See also *Palmer v. Bender*, 287 U.S. 551 (1933).

Revenue Ruling 64-75, 1964-1 C.B. 228, holds that where the owner of mineral-bearing real property subject to leases under which the minerals are extracted in exchange for payments that are determined primarily by reference to the amount of minerals mined, the owner’s interests in the real properties are “mineral royalty interests” rather than “real estate assets” for purposes of section 856(c)(5), and revenues derived from its leases do not qualify as “rents from real property” under sections 856(c)(2) and (3). The owner’s property interest was deemed a mineral, oil, or gas royalty interest because the receipts fell “within the normal and ordinary meaning of the term ‘royalty.’”

Revenue Ruling 85-16, 1985-1 C.B. 180, explains that a mineral royalty is generally a payment (1) based on a fixed percentage of production, or a share of net profits from production, received by a person with a right to the minerals in place; (2) for permitting another to extract and take those minerals; and (3) payable only from the minerals produced or the proceeds derived from the disposition of those minerals. Consequently, the ruling holds that a taxpayer’s “mining tax” payments to the government of the Province of Ontario, Canada were not royalties for purposes of determining percentage depletion deduction under section 613 of the Code. Even though such payments were referred to as royalties on some forms and were measured by reference to mining profits, they were not treated as royalties because, among other reasons, the Province of Ontario retained no rights to any mineral mined or income therefrom and did not participate in any mining risks.

In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1532 (9th Cir. 1996), the court found that the ordinary meaning of the term royalty is “a payment made to the owner of property for permitting another to use the property,” and that “[t]he payment is typically a percentage of profits or a specified sum per item sold; the property is typically either an intangible property right . . . or a right relating to the development of natural resources.” Therefore, the court found that it was the “nature of the property the owner is permitting another to use” that differentiates a royalty from rent. The court based its

conclusion on definitions of “royalty” in Webster's Ninth New Collegiate Dictionary (“share of the product or profit reserved by the grantor [especially] of an oil or mining lease . . .”) and Black’s Law Dictionary (“compensation for the use of property, usually copyrighted material or natural resources, . . . share of product or profit reserved by owner for permitting another to use the property”).

Revenue Ruling 79-144, 1979-1 C.B. 219, holds that payments received under a lease of surface rights, even when measured by reference to coal mined from that area under a coal lease with a third party, are not proceeds from the disposal of coal within the meaning of section 631(c), but are instead ordinary income received in return for the right to use the surface overlying such coal. See also *Omer v. United States*, 329 F.2d 393 (6th Cir. 1964); *Estate of Reinke v. Commissioner*, 46 F.3d 760 (8th Cir. 1995).

In *Vest v. Commissioner*, 481 F.2d 238 (5th Cir. 1973), cert. den. 414 U.S. 1092, a lease between surface owners, as lessor, and holders of certain mineral rights, as lessee, required lessee to pay lessor specified amounts for well locations and other uses of the surface, in addition to compensation for all actual damage caused to the surface. The court concluded that payments for the surface rights were in the nature of rental income.

The Payments constitute amounts received for the use of, or right to use, the Surface Estate, and are not based on the income or profits of Mining. The Payments therefore constitute rents from real property if LLC’s interest in the Surface Estate is an interest in real property. The Property is land, and the Surface Estate is an ownership interest in that land. The Surface Estate therefore is an interest in real property for purposes of section 1.856-3(c) and real property for purposes of section 1.856-3(d), unless LLC’s property interest is a mineral royalty interest described in section 856(c)(5)(C).

LLC’s interest is not “a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply,” which would be a mineral royalty interest under section 1.856-3(c). See Rev. Rul. 79-144. LLC’s interest in the Property is also not a royalty interest within the ordinary meaning of the term. Unlike the taxpayer in Revenue Ruling 64-75, LLC did not hold an interest in minerals, and therefore did not transfer such an interest to a lessee and retain a royalty interest. LLC’s interest is only in land, and periodic payments for the use of land are ordinarily treated as rent.

The fact that LLC’s rights under local law are only to the surface of the Property is not determinative of the nature of its property for purposes of section 856. The facts here, however, do not suggest that LLC has an economic interest in the minerals that would cause its interest in the Surface Estate to be treated as a royalty interest. Mining has the right to terminate the SUA without penalty. LLC has no right to, or control over, any minerals on the Property. Mining has the right to mine the Property without the consent of LLC. LLC’s receipts are measured by reference to the quantity and sales

price of Mineral mined, but section 856(d)(2)(A) expressly permits rents to be based on receipts or sales.

Moreover, the circumstances indicate that the Surface Estate and SUA were not a means by which Taxpayer could acquire an investment that was in form an interest in real property but in substance a mineral royalty interest. The Payments under the SUA were negotiated at arms length by unrelated parties prior to Taxpayer's investment. The Payments relate to the surface, because what the lessor surrendered in exchange for the Payments was the right to damages for destruction of the surface.

Because LLC is a disregarded entity, Fund is the owner of the Surface Estate for federal income tax purposes. Taxpayer is deemed to own a percent of the Surface Estate and is deemed to be entitled to a percent of the Payments. The character of the property interest in the Surface Estate and the character of the Payments remain the same in the hands of Taxpayer for purposes of section 856.

Conclusion

Based on the facts as represented by Taxpayer, we rule that the gross income realized by Taxpayer from the Payments constitutes rents from real property for purposes of sections 856(c)(2) and 856(c)(3) of the Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed on whether the Taxpayer qualifies as a REIT or the treatment of the Payments for any purpose other than section 856(c)(2) and (3).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Jonathan D. Silver
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Assistant to the Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)